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No. 90-1361

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Supreme Court of the United States

OCTOBER TERM, 1990

HOLYWELL CORPORATION, MIAMI CENTER LIMITED PARTNERSHIP, MIAMI CENTER CORPORATION, CHOPIN ASSOCIATES, AND THEODORE B. GOULD,
Petitioners,

v.

FRED STANTON SMITH, BANK OF NEW YORK, SHUTTS & BOWEN, AND THE UNITED STATES OF AMERICA,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

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REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR THE PETITIONERS

The respondents' briefs underscore the importance of this case and the indefensibility of the court of appeals' ruling that a "liquidating trustee" need not file federal income tax returns and pay federal taxes if he is appointed as part of a chapter 11 plan of reorganization.

The United States has filed a petition for certiorari to review the judgment below, saying that this case deserves a place on this Court's docket because the ruling below "threatens to create a tax loophole of troubling proportions," "cannot be reconciled with the broad language of the statute," and "conflicts with the decisions of other courts of appeals." [1]

Respondents Fred Stanton Smith (the trustee) and The Bank of New York (BNY or Bank) do not seriously defend the court of appeals' decision. They do not argue that their position is supported by the plain language of the statutes; indeed the trustee argues that he variously is—and is not—a trustee in "a case under title 11" (*compare* Smith Br. 11-12 *with* Smith Br. 26) and the Bank argues that the same words in two statutes *in pari materia* (and indeed enacted as part of a comprehensive treatment of the same subject [2]) mean different things (BNY Br. 22 n.24). Respondents do not dispute that the proper interpretation of these statutes is an issue of recurring national importance. And they do not reconcile the decisions of every other court of appeals to have considered I.R.C. § 6012(b); indeed the Bank concedes that many of those decisions involve so-called "contract" trustees (BNY Br. 24). Instead, they raise a number of side issues that serve only to demonstrate how desperate they are to evade this Court's scrutiny.

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[1] Petition for a Writ of Certiorari in *United States* v. *Smith*, No. 90-1484 (filed March 20, 1991) at 8, 14, 18.

[2] Bankruptcy Reform Act of 1978, Pub. L. 95-598, § 322, 92 Stat. 2549, 2628-79; Bankruptcy Tax Act of 1980, Pub. L. 96-589, § 6(i)(5), 94 Stat. 3389, 3410.

1. *"We Intended This and It's Too Late to Do Anything About It."* —The trustee and the Bank contend that it was the intent of the Bank's Plan that the federal income taxes arising from the trustee's sale of the Miami Center not be paid out of the Trust's assets; that thereafter federal income taxes on the interest income and other taxable increase on the funds in the hands of the trustee were not to be paid; and that, indeed, this was an essential element of the Plan, necessary in order to make it successful. Smith Br. 3, 5-6, 8, 9-10, 18-19; BNY Br. 9, 14-16, 27. They say that the United States should have been on notice that the trustee would refuse to follow the command of three separate federal statutes to file returns and pay taxes because the Plan did not contain a provision expressly providing for the payment of taxes by the trustee. Smith Br. 5-6, 9-10, 18-19; BNY Br. 8, 13, 27.[3]

Related to this point, the trustee and the Bank now say that the issue raised by this case, and by our and the

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[3] The trustee argues (Smith Br. 21) that the payment of federal income taxes is not an expense of administering the trust under the terms of BNY's Plan because it is not a cost of "operating [the debtors'] businesses." This argument ignores the sweeping powers granted to the trustee (*see* pp. 7-8, *infra*) and the obligation to pay federal taxes imposed by 28 U.S.C. § 960 on an officer of the court who is "conducting any business" and by section 6012(b)(3) "whether or not such property or business is being operated."

We also note that the Reorganization Plans proposed by the debtors estimated that the federal income tax liabilities would exceed $22 million. The assertion that the debtors' Plans did not provide for such taxes (Smith Br. 3 n.5, 5; BNY Br. 12) is wrong. Liquidation Analyses, Exs. E to Disclosure Statements and Plans of Reorganization of Debtors Holywell and Theodore B. Gould (filed February 15, 1985) (Bankr. C.P. Nos. 377, 381). In addition, the Bank's assertion that the debtors once took the position that the trustee "was not required to file returns or pay income taxes with respect to the debtors' income" (BNY Br. 4) is false, as is revealed by the exhibits the Bank points to for support. The debtors in fact took the position that the Liquidating Trust was not a new "taxable entity" but that the trustee was required to file returns and pay taxes on the same basis as if its income were earned by the various debtors.

United States' Petitions, is moot. Smith Br. 17-18; BNY Br. 15-16. Why is this? Because, they say, the United States did not perceive that it was the Bank's intention that the trustee should be exempt from the payment of federal income taxes; and the United States, accordingly, did not object to the Plan.[4] It was, they say, also because the debtors—who did object to the Plan on various grounds, including that it did not affirmatively provide for the payment of taxes—did not happen to have $50 million available to obtain a stay of the consummation of the Plan. The trustee has thus, they say, through the "mootness" doctrine, achieved a permanent exemption from the statutes requiring him to pay federal income taxes.[5]

Acceptance of these remarkable contentions would afford great possibilities in the structuring of plans of reorganization for troubled enterprises. The potentials in the tax area are made obvious by this case. Other ap-

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[4] Respondents' related assertion (Smith Br. 18-20; BNY Br. 7, 13) that the United States is estopped from collecting these taxes because it did not file a "proof of claim" for them shows a misunderstanding of the nature of post-petition taxes. The taxes at issue here accrued subsequent to the filing of the bankruptcy petitions. While a proof of claim is required for the recovery of pre-petition taxes, no proof of claim need be filed for the recovery of post-petition taxes, because such taxes, at least as long as the case is open, are "administrative expenses" squarely within the coverage of 11 U.S.C. § 503(b)(1)(B) (1988). *See, e.g., In re Gonzalez*, 112 Bankr. 10, 11 (Bankr. E.D. Tex. 1989) ("It is axiomatic that there can be no Proof of Claim filed for a post-petition tax liability."); *In re Spruill*, 78 Bankr. 766, 722 (Bankr. E.D.N.C. 1987) ("A claim for a tax which arose postpetition . . . is not made through a proof of claim"). Clearly, the taxes accruing after the Plan was confirmed, as an *a fortiori* matter, did not have to be the subject of a proof of claim; the time for filing proofs of claims was by then long past.

[5] With about $25 million remaining in the trustee's control—$11 million of which he has recently told the bankruptcy court should be paid to BNY pursuant to a "Trustee's Certificate"—we find it hard to imagine how anyone could conclude this matter is "moot" and not a live case or controversy.

plications may be suggested. An industrial company that found compliance with the Occupational Safety and Health Act ("OSHA") financially burdensome could reorganize in chapter 11 and thereafter contend that the failure to include a provision in the plan requiring the reorganized company to comply with OSHA meant that it need not comply, since it could not profitably operate while bearing the pecuniary burdens of compliance; and thus the plan would be "frustrated" if it did comply.

Whatever may be the effect of the present revelations as to the Bank's intent in proposing the Plan and the trustee's in acting under it,[6] the court of appeals did not hold that its exploration of the matter now raised by the petitions for certiorari was moot or precluded in any way by the consummation of the Plan of Reorganization. Instead, the court held that "the allegation that certain provisions of the Plan and/or provisions of the Income Tax Code [*sic*] require the liquidating trustee to file and pay income taxes is not an attempt to modify or alter the Plan. . . . Thus, we address the merits of this claim . . . ."[7] The court of appeals thus did not equate the Plan's silence on the matter of the trustee's obligation to pay federal income taxes as tantamount to an affirmative provision purporting to relieve the trustee from his statutory obligation to do so.

Respondents' argument (rejected by the court of appeals) that the United States should have sooner pursued the trustee for his intention—whether covert or overt—not to file tax returns, turns the statutory scheme on its head. The trustee's relationship with taxing authorities is unlike his relationship with any other creditor. Section 960 of the Judicial Code makes it clear that, as an officer

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[6] After receiving an indemnity letter, of course not provided for by the Plan, from the Bank.

[7] Pet. App. 7a; 911 F.2d at 1544. The only matters the court of appeals held "moot" were the trustee's allegation that BNY committed fraud by not disclosing that the Plan did not expressly provide for the payment of taxes and the challenge to the approval of the Plan. Pet. App. 6a-7a; 911 F.2d at 1548.

of the court, the trustee must pay taxes on his own initiative. Section 960 prescribes a standard of conduct for the *trustee*, not for the taxing authorities. Similarly, I.R.C. § 6012(b) places the burden on the trustee to file returns, thereby providing the United States with sufficient information to understand the tax liabilities, and requires the trustee to pay the taxes in the ordinary course.[8] A similar obligation is imposed on trustees not appointed by courts. I.R.C. § 6012(b)(4). A similar, absolute obligation is imposed on insolvency trustees, assignees and receivers, under pain of personal liability. 31 U.S.C. § 3713(a). These laws simply do not permit the trustees to ignore his legal obligations to the United States—obligations that do not depend in any way on the filing of a proof of claim or the direction in a Plan that he pay—or not pay—taxes.

If the respondents' apparent suggestion is correct that the Bank's Plan intended (contrary to the court of appeals' understanding) to prohibit the trustee from paying taxes notwithstanding the statutory commands, the case takes on another aspect which would indicate a further reason for granting certiorari. The respondents say the court of appeals' decision should be left unreviewed because of this alleged adequate alternative ground. But acceptance of that ground involves a startling proposition —that the terms of the Plan could exempt an entity created by the Plan from compliance with generally applicable Federal statutes.

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[8] In this regard, respondents attempt to justify the court of appeals' decision by relying on a case nowhere mentioned by that court—*In re International Horizons, Inc.*, 751 F.2d 1213, 1215 (11th Cir. 1985). But there, the IRS had notice—through the filing of federal income tax returns—of *past due* taxes (for a period prior to the filing of the bankruptcy case), but did not timely file a proof of claim in the bankruptcy court. Here, in contrast, the trustee never filed the income tax returns. Indeed, in *Nicholas* v. *United States*, 384 U.S. 678, 692-94 (1966), this Court held a bankruptcy trustee liable for penalties imposed by the Internal Revenue Code for his failure to file tax returns.

2. *"The Debtors Were Grantors of a Grantor Trust."* —Respondents contend that the debtors (who objected to the Plan) have nonetheless made voluntary transfers to a trust over which they retained dominion and control sufficient to be treated as the Trust's "owner" under the grantor trust provisions of the Internal Revenue Code, I.R.C. §§ 671 to 679. Smith Br. 24-26; BNY Br. 21 n.23. Although the trustee and the Bank made this argument in the court of appeals, the court did not adopt it. That is because the debtors neither made a voluntary transfer nor retained the kind of dominion and control necessary to be treated as an "owner" under the grantor trust rules. *See generally* 3 B. Bittker, *Federal Taxation of Income, Estates & Gifts*, ¶¶ 80.1.1, 80.1.5 (1981). To be sure, the filing of the petitions in chapter 11 reorganization here was voluntary by the debtors, but they neither proposed nor consented to the Plan and indeed strenuously objected to it. The notion that the debtors retained dominion and control over the Liquidating Trust is ludicrous; the Plan providing for the Liquidating Trust was put forward by the debtors' principal creditor and strongly resisted by the debtors; the trustee was personally indemnified by a side letter from that creditor; and the trustee and the debtor have been at loggerheads ever since.

The Ninth Circuit (the only court of appeals to have addressed this question) has held that the grantor trust provisions of I.R.C. §§ 671 to 679 are inapplicable in bankruptcy. *DePinto* v. *United States*, 585 F.2d 405, 407 (9th Cir. 1978). In fact, a leading bankruptcy authority considers the single bankruptcy case relied upon by respondents, *In re Sonner*, 53 Bankr. 859 (Bankr. E.D. Va. 1985), to be "one of the more troubling cases" in the area and concludes that "the *Sonner* decision reaches a harsh result using a strained application of the grantor trust provisions . . . ." 1 L. King, *et al.*, *Collier on Bankruptcy* ¶ 8.02 at 8-15 to 8-16 (15th ed. 1990). Indeed, if respondents were correct, all bankruptcy trustees, or at least those where the petition in bankruptcy was filed voluntarily—including those conceded by all to come within

the language of section 6012(b)(3)—would be exempt from that section's requirements, making the statute requiring bankruptcy trustees to file tax returns and pay taxes largely a dead letter.

3. *"The Trustee was Just a Disbursing Agent."*—The respondents' further contention (Smith Br. 27-30; BNY Br. 17-22) that the trustee was the equivalent of a "disbursing agent" under section 3§7(1) of the Bankruptcy Act of 1898,[9] with only "ministerial" duties, does not comport with the sweeping discretion in fact vested in the trustee, who possessed total control over all the debtors' assets. He had the power to sell, manage, operate, lease, mortgage, or otherwise "release, convey or assign any right, title or interest in or about the Trust Property." Pet. App. 44a. He had the power to employ attorneys, accountants and, interestingly, "tax specialists"; to prosecute, defend, settle or discontinue any disputes or litigations of the debtors; and to waive any of their rights. Pet. App. 45a. He had the right to "[d]eal with the Trust Property or any part or parts thereof in all other ways as would be lawful for any person owning the same to deal therewith, whether similar to or different from the ways above specified, at any time or times hereafter." Pet. App. 45a-46a. The only restriction on the trustee's power was that he could "[t]ake no action that would change the business of any of the Debtors . . . ." Pet. App. 46a.

If that were not enough, the Plan went on to make the total control by the trustee crystal clear: "as to any party dealing with the Trustee in any manner whatsoever in relation to the Trust Property, the power of the Trustee to act or otherwise deal with said properties shall be absolute."[10] The Bank argues that—notwithstanding

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[9] Formerly codified at 11 U.S.C. § 737(1) (1976) but omitted from the Bankruptcy Code of 1978.

[10] Amended Consolidated Plan of Reorganization Proposed by the Bank of New York, art. V(4) (March 26, 1985) (Bankr. C.P. No. 479).

these powers (and the statutes' plain language)—Congress somehow intended to distinguish between *this* trustee and "statutory trustees." That theory comes out of thin air: there is no support for it in any case, in any commentary or in any legislative history. The pertinent term ("trustee in a case under title 11") is not defined by statute. The theory is also contrary to the facts: the trustee in this case posted a bond—as required by 11 U.S.C. § 322(a)—and filed a statement that he was a "disinterested party" —as required by 11 U.S.C. § 1104(c).[11] The trustee has initiated and defended numerous litigations; has compromised litigation; has frequently applied to the court for instructions and taken positions on such applications. Indeed, a trustee with narrower powers appointed outside of court proceedings—to hold specific investments and pay the dividends over to a series of named beneficiaries, for example—has the duty to file tax returns and pay taxes. I.R.C. § 6012(b)(4). The distinction asserted by the Bank is thus one between this trustee and the whole universe of other trustees.

The argument that the trustee had only "ministerial" duties and was somehow bound by the Plan not to file the federal income tax returns and pay taxes also is directly contrary to this Court's decision in *King* v. *United States*, 379 U.S. 329, 338-39 (1964), that a disbursing agent under the old Bankruptcy Act may be held personally liable (under the predecessor to 31 U.S.C. § 3713(b)) for paying private claims ahead of Government claims in liquidating a bankrupt estate because of the control he in fact exercises. The holding of *King* turned on the disbursing agent's *actual* power, not on the supposedly "distinguishing facts" pointed to by the trustee. Smith Br. 12.

It is hard to imagine how this trustee was not (and does not remain) an "officer" or "agent conducting any business under authority of a United States court" under

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[11] *See* Order Appointing Trustee (August 12, 1985) (Bankr. C.P. No. 916); Trustee's Acceptance of Appointment (August 20, 1985) (Bankr. C.P. No. 919).

28 U.S.C. § 960 and *California State Bd. of Equalization* v. *Sierra Summit, Inc.*, 490 U.S. 844, 853 (1989).[12] Moreover, respondents' argument ignores the interlacing statutes that we and the United States set out in our petitions for writs of certiorari. Respondents virtually ignore the plain language of three statutes now on the books and instead engage in textual exegesis of cases decided under a provision of the now-repealed Bankruptcy Act of 1898 that has no present-day equivalent. *See* Smith Br. 13-14, 27; BNY Br. 19-20.

* * * *

As we explained in our Petition, there is no dispute that if the estate had been liquidated by the debtors-in-possession under court supervision, or by a trustee elected under chapter 7, or even by a trustee appointed during the administration of the case under chapter 11 (rather than by a so-called "liquidating trustee"), the capital gains taxes and other income taxes on income earned by the trustee would have been entitled to first priority as administrative expenses. *See* 11 U.S.C. §§ 507(a)(1), 503(b)(1)(B). By a stroke of the pen, BNY claims to have eliminated that administrative expense priority. Indeed, had the trustee been appointed

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[12] The trustee lamely argues only that the lower courts' supposed determination that the trustee was not "conducting any business" is an "evidentiary matter" not subject to review. Smith Br. 11, 22. That is frivolous. In point of fact, the bankruptcy court (which observed that "the facts are not in serious dispute" (Pet. App. 29a)) heard no testimony, reviewed nothing but legal memoranda, and made *no* findings about whether the trustee was "conducting any business." The district court attempted to distinguish this Court's decision in *Sierra Summit* not by making findings of fact about whether the trustee was "conducting any business," but with the irrelevant and incorrect observation that 28 U.S.C. § 960 is inapplicable because the trustee "here is not a 'trustee in bankruptcy' [language no longer in the statute] subject to the provisions of 26 U.S.C. § 6012." Pet. App. 26a. The Bank's attempt to distinguish *Sierra Summit* by arguing that section 960 does not apply unless another statute "imposes tax" (BNY Br. 28 n.24) is even more nonsensical. The "other" statutes here are I.R.C. §§ 1 and 11, which impose taxes on the income of individuals and corporations.

entirely outside the context of court proceedings, he would still have been required to file federal income tax returns and pay federal income taxes. *See* Pet. 24-25. The same stroke of the pen is said to have eliminated this obligation as well.[13]

If indeed it is viewed as purporting to immunize the trustee from obligations to pay federal income tax, BNY's Plan permitted the creditors (especially BNY itself) to obtain a windfall without competition from the Government's claim for federal income taxes. The extraordinary arguments made by respondents suggest that the Plan may have been conceived in the desire for tax avoidance, and suggest the importance of granting certiorari lest the scheme be sanctioned and be repeated by others.

For the foregoing reasons, and for the reasons stated in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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May 1991

[13] The Bank makes a series of other arguments that seem to underscore the lack of basis on which to support the judgment below: Because no one knows for sure the exact amount of taxes the trustee should have paid (because the trustee didn't file tax returns), the trustee doesn't have to file tax returns (BNY Br. 4); because the debtors might somehow be able to pay the taxes, the party required by at least three acts of Congress to pay them ought not to pay them (BNY Br. 8); and because the trustee supposedly doesn't have the necessary information to file tax returns (although the Plan vested him with ownership of all of the debtors' nonexempt property, including their books and records, and obviously is familiar with the transactions and income of the trust monies in his hands), the trustee shouldn't have to file returns (BNY Br. 20). In fact, we understand that the IRS has now completed its audit and tentatively recommended taxes, penalties and interest in the amounts of more than $33 million for Holywell and $2.5 million for Mr. Gould for the year in which the Miami Center was sold.